

# Can Drastic Deficit Reduction Help Economic Recovery?

## Prospects for UK, US and Southern Europe

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Drastically reducing fiscal deficits has been increasingly advocated as an urgent priority across Europe and the US. The election of a Conservative-led coalition government in the UK in the Spring of 2010 and the Eurozone crisis and sovereign bail-outs during 2011 have motivated this recent fixation with fiscal retrenchment.

Once elected, The UK's coalition government was quick to announce ambitious targets for public sector net borrowing for the fiscal period 2009/10 to 2015/16. As the table below documents, it aimed to quickly reduce such borrowing from 11% of GDP to 1.1% of GDP, mainly via expenditure cuts.

Such an agenda would imply eliminating the deficit on the current budget by 2015/16. The government argued in its October 2010 spending review (HM Treasury, 2010) that failure to take such action would put the UK's economic recovery at risk and place an unfair debt burden on future generations.

In its 2011 budget statement (HM Treasury, 2011), it has re-affirmed its ambitious fiscal targets though it has also exhibited a new interest in stimulating private investment -- apparently fearing that economic growth was beginning to falter.

**Table: Office of Budget Responsibility Forecasts for the UK's Public Borrowing 2009/10-2015/16**

	2009/ 2010	2010/ 2011	2011/ 2012	2012/ 2013	2013/ 2014	2014/ 2015	2015/ 2016
Public Sector Net Borrowing	11.0	10.1	7.5	5.5	3.5	2.1	1.1
Budget Deficit	-7.5	-7.5	-5.7	-4.0	-2.3	-0.9	0.0

Source: HM Treasury, 2010

In recent months, Ireland and countries in Southern Europe (especially Greece and Portugal) have been put under mounting pressure to adopt similarly demanding fiscal targets. Most recently, the budget debate in the US has dramatically flared up, with Republicans in the House of Representatives leading intense lobbying for a radical slashing of public expenditures.

### The Likely Economic Impact

In this Development Viewpoint, we try to assess the likely economic impact of the widespread adoption of radical deficit reduction. In order to do so, we conduct an experiment in which all countries that could be considered 'at risk' (namely, Greece, Ireland, Portugal, Italy, Spain and the US) replicate the UK's target of reducing public sector net borrowing to 1.1% of GDP by 2015.

However, in order to ensure the realism of this experiment, we also assume that oil prices will rise by a third over the course of 2011, driven principally by the ongoing political turmoil in the Middle East and the nuclear energy scare in Japan. This is a sensible assumption given recent trends.

Our approach is to use the 'State of the World Economy' global macroeconomic model to compare two basic scenarios (See [SOWE](#) for more information on the model). The first scenario is the 'business as usual', or baseline, scenario, in which current trends are simply projected through 2015. The second scenario alters this baseline by introducing the fiscal retrenchment and the oil price shock that we have described above.

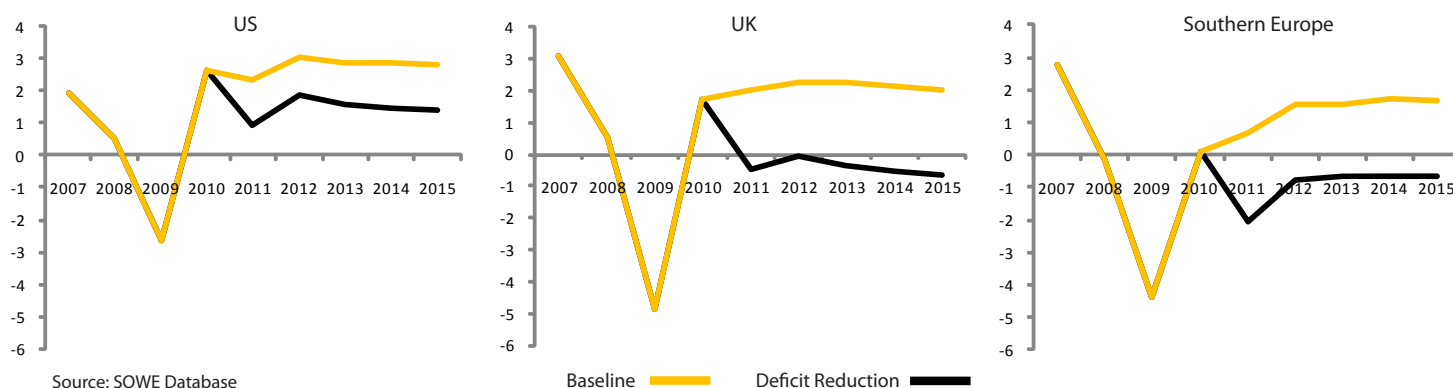
Our main concern is to evaluate the likely impact of the second scenario, through 2015, on the countries undertaking drastic belt tightening. The data for the SOWE model allow us to assess the impact on Southern Europe as a whole and both the UK and the US individually. Though we are also concerned about the impact of deficit reduction on trends in the global economy, developing countries and other developed economies, these are not the focus of this Development Viewpoint.

In assessing impact, we concentrate on changes in several macroeconomic variables: GDP, employment, private investment and public debt as a ratio to GDP.

### Regression to Recession

What is the projected impact on the UK and Southern Europe? They both fall back into a recession over the course of 2011 and 2012 and remain in such a condition until 2015 (See Figure 1). While the US is not projected to fall into recession, its average GDP growth rate remains 1-2 percentage points lower than in the baseline scenario. As a result of these effects, the growth of world income remains about one percentage point lower than in the baseline until 2015.

**Figure 1: GDP Growth Rates (%) in the US, UK and Southern Europe under the Baseline and the Deficit Reduction Scenarios**



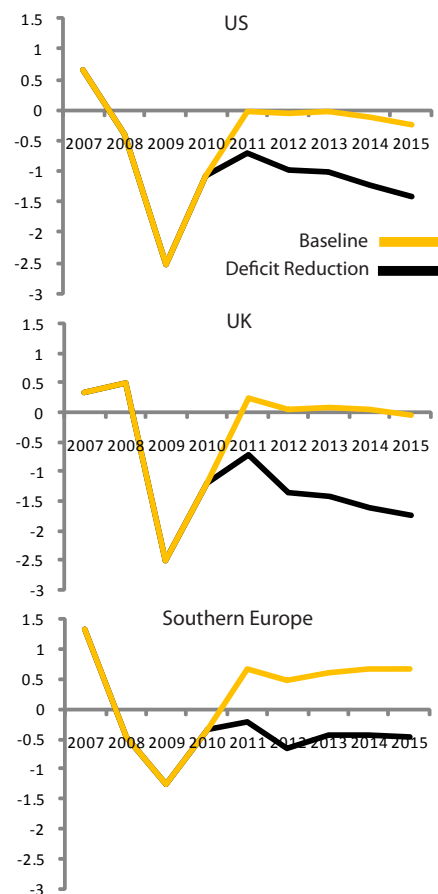
The fiscal retrenchment, not higher oil prices, appears to be the main source of the projected contractions in GDP in the 'at-risk' economies. One supporting piece of evidence is that other countries and regions are only marginally affected by the deficit-reduction scenario.

Major developed and emerging countries and regions maintain roughly similar GDP growth rates as in the baseline scenario. For example, GDP growth rates in Germany, China and Japan are less than 0.25 percentage point lower in this scenario than under the baseline for the period up to 2015.

### The Spectre of Unemployment

A particularly disturbing trend is the growth in unemployment across the countries adopting fiscal retrenchment. The UK and the US are particularly affected. In the UK employment figures for 2010 and early 2011 have already shown signs of decline. In fact, in March 2011 unemployment in the UK hit a 17-year high ([BBC website](#)). The coalition government's continued pursuit of aggressive budget cutting is projected to turn growth rates of employment negative starting in 2010 (see figure 2).

**Figure 2: Employment Growth Rates (%) in the US, UK and Southern Europe under the Baseline and the Deficit Reduction Scenarios**



Source: SOWE Database

In the US, budget tightening is likely to jeopardize the recent trend of falling unemployment due to economic recovery. Similar to the UK, the US is also projected to experience negative 1-2% employment growth (i.e. rising unemployment) each year until 2015.

Southern Europe is also projected to experience negative growth of employment, although to a lesser degree than in the US and UK.

### Private Investment

In the UK, the Tory-led government has argued that the large public expenditures under previous Labour governments crowded out private investment. Thus, substantially reducing public expenditures, it contends, should boost confidence in the private sector and lead thereby to significant increases in private investment.

Unfortunately, our model's projections offer little support for such predictions. As a ratio to GDP, private investment remains largely unchanged in the UK, the US and Southern Europe. It is not surprising, therefore, that our scenario projects overall declines in GDP and employment: the lacklustre performance of private investment fails to compensate for the substantial fall in aggregate demand triggered by hefty budget cuts.

### Public Debt to GDP

One of the major motivations of the UK's coalition government for eliminating the fiscal deficit by 2015/16 is to set public-sector debt on a downward trajectory. However, our scenario for fiscal retrenchment suggests that in the US and the UK, public debt as a percentage of GDP would remain largely unchanged through 2015, compared to the trend for the baseline scenario, and that this ratio would increase for Southern Europe.

Upon reflection, such results are not surprising given the projected declines in GDP (the denominator of the ratio) as a result of the throttling of aggregate demand through public-sector cutbacks.

### Summary

This Development Viewpoint has illustrated that if the Tory-inspired public belt tightening is adopted as well by the US and the countries 'at risk' in Southern Europe, the medium-term economic impacts through 2015 would be severe. Not only would the growth of GDP and employment be negatively affected, but also private investment would languish and the ratio of public debt to GDP would not, in fact, fall, and would even likely rise for some countries.

Though policies of fiscal retrenchment are hailed by many conservative economists as a necessary remedy—and even begrudgingly supported by numerous other 'progressive' economists as inescapable—our model projections suggest that the outcomes will largely be counter-productive, and principally for the countries being currently counselled to implement them.

### References:

- HM Treasury (2011). *Budget 2011*, TSO: Norwich, March 2011
- HM Treasury (2010). *Spending Review 2010*, TSO: Norwich, October 2010